



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

May 9, 2006

Memorandum

TO: Governor Phil Bredesen

Chairman Douglas Henry, Jr.
Senate Finance, Ways, & Means Committee

Chairman Craig Fitzhugh
House Finance, Ways, & Means Committee

FROM: John Morgan, Comptroller of the Treasury *M*
Riley Darnell, Secretary of State *R.D.*
Dale Sims, State Treasurer *DS*
M.D. Goetz, Jr., Commissioner
Department of Finance & Administration *MDG*

SUBJECT: Revenue Estimates for FY 2005-06 and FY 2006-07

The State Funding Board met on May 3, 2006 to hear updated presentations on, and to engage in discussions about, the State's near-term economic outlook for the fiscal years 2005-06 and 2006-07. During this meeting, the Board heard economic testimony from Dr. William Fox of The University of Tennessee, Mr. Jim White of the Fiscal Review Committee, and Mr. Reid Linn of the State Department of Revenue. The state tax revenue estimates provided by each of the presenters are summarized in two attachments to this memorandum.

The Board is charged with responsibility to develop consensus ranges of state revenue growth. In doing so, the Board evaluates and interprets economic data and revenue forecasts supplied by various economists as well as persons acquainted with the Tennessee revenue system. Since this is a revenue estimation process and **not** a

budgeting process, the Board does not take into consideration the State's fiscal situation when developing its consensus ranges of revenue growth. Fiscal considerations properly belong with those who set the State's revenue estimates - the Administration that recommends appropriation levels based upon its assessment of revenue growth and the General Assembly that adopts a *de facto* revenue estimate through its final action on the appropriations bill.

The consensus is that the economy is growing, but that growth is slower than in the prior months. There is a decline in new housing starts. The US trade deficit is at a high of 7% of GDP. Tennessee continues to experience some job growth (non-agricultural jobs), but wage growth is low. Tennessee's tax system depends upon healthy growth in sales tax collections. In reviewing sales tax collections by categories, Dr. Fox specifically remarked upon the sales tax on food as being a slow growing but stable tax stream. He also remarked that the Department tracks the sales tax by vendor category. Sales tax collections on food from vendors whose primary business is other than food (i.e. Wal-Mart usually is classified in the general merchandise category) is reflected in a different category than vendors whose primary business is the sale of food (i.e. Kroger is classified in the food store category).

Households are continuing to spend without significant growth in personal income, resulting in negative household savings.

Presenters also acknowledged the difficulty in accurately estimating franchise and excise tax collections. Nationally, corporate excise tax collections are strong. Tennessee's franchise and excise tax quarterly payments in September and January were undercollected but April was overcollected. The presenters differed in how to interpret the trend, if any, indicated by the April payment. State tax law changes closing loopholes have improved the base. However, it was acknowledged that continued changes to the statutes will be needed as corporate taxpayers identify ways to minimize payment of the tax.

Based on the testimony received and the Board discussions, the Board determined to revise for fiscal year 2005-06 the consensus estimates previously agreed to in December 2005.

	FY 2005-06		FY 2006-07	
	Low	High	Low	High
Total State Taxes	5.85%	6.40%	3.50%	3.75%
General Fund Only	6.05%	6.65%	3.80%	4.05%

The Board believes the consensus revenue growth ranges in the chart above to be reasonable and appropriate for use in state budgeting. The ranges for fiscal year 2005-06 have been increased from those we presented in December 2005. Although the top end of the ranges for fiscal year 2006-07 were lowered, they are to be applied to the higher

beginning base. Due to the volatility of the Franchise and Excise tax collections, the decision to utilize the higher growth range for budgeting purposes for fiscal year 2006-07 should be reached cautiously.

Additionally, the State Funding Board received presentations regarding the Tennessee Education Lottery (TEL). Mr. Robert N. Currey, Fiscal Analyst with the Fiscal Review Committee (FRC), presented the Board the FRC's revised projections. Mr. Currey reviewed the fiscal year 2005-06 through March 31, 2006 performance of the TEL, including \$207,400,000 in Net Lottery Proceeds (compared with the Fiscal Review Committee original estimate of \$177,000,000). Mr. Currey confirmed his prior forecast of continuing increased revenues for the fiscal year due to a continued higher prize payout strategy, a Powerball matrix change, and mid-day drawings for CASH 3 and 4. Mr. Currey cautioned that long-term use of a higher payout strategy could lead to the point where subsequent increases to the prize payout ratio will have no or negative effect (the incremental revenue is less than the incremental increase in expenses).

For fiscal year 2005-06, the FRC attributed variance in actual versus estimated net lottery proceeds to the following factors. Projected Net Revenue exceeded estimated revenue by 12.6%. A 10.8% growth rate in expenses as a percent of revenue constant, and actual Net Lottery Proceeds exceeded the estimate by 17.3%. For fiscal year 2005-06, the revised FRC estimate for Net Lottery Proceeds is a low of \$263,586,000 and a high of \$271,432,000.

For fiscal year 2006-07, the FRC projected a 2.0% growth rate in Net Revenue, a 2.7% growth rate in expenses as a percent of revenue constant, and a 0.2% growth rate in Net Lottery Proceeds. For fiscal year 2006-07, the FRC revised estimate for Net Lottery Proceeds is a low of \$264,141,000 and a high of \$272,004,000. The amounts are 28.5% and 28% of Net Revenue, respectively. Caution was expressed that revenues that become available for pre-school and after-school programs should be considered a nonrecurring revenue source and expenditures of these funds should be for non-recurring items.

The Board additionally heard from Ms. Rebecca Paul, the Chief Executive Officer and President, and Mr. Andy Davis, Chief Financial and Technology Officer of the TELC. The deposit to the Education Account for fiscal year 2005-06 through March 31, 2006 was \$207,400,000. The TELC is continuing to estimate approximately 2% of prizes (excluding jackpot prizes) to be the estimated amount for unclaimed prizes; 50% of which is to be redeposited for use as prize payouts and 50% be deposited into the "after school programs special account" at the end of each fiscal year. He noted that there is legislation pending that would change the use of the unclaimed prize money; his estimates assume no legislative changes. Lottery sales for fiscal year 2005-06 through March 31, 2006 have generated \$5,700,000 due to the after school programs special account.

Net Revenue through March 31, 2006 for fiscal year 2005-06 was \$711,100,000. The TELC's estimate of Net Lottery Proceeds available for deposit into the Education Account for fiscal year 2005-06 is from a low of \$260,100,000 to a high of \$268,100,000; and for fiscal year 2006-07 is from a low of \$261,900,000 to a high of \$272,600,000. These amounts are 28.6% and 28% respectively of Net Revenue.

The Board then heard from Dr. Robert Ruble, Executive Director, and Mr. Robert Biggers, Director of the Lottery Scholarship Program, of the Tennessee Student Assistance Corporation. In fiscal year 2004-05, there were 40,225 awards in the TEL Scholarship program, with an actual cost of \$93,416,022. Dr. Ruble presented his projections for fiscal year 2005-06 at 56,000 with a projected cost of \$137,000,000, below the previously projected 61,245 awards, with a projected cost of \$168,066,080. Dr. Ruble revised the fiscal year 2006-07 projections to 62,000, with a projected cost of \$179,000,000 from 72,571 awards, with a projected cost of \$206,172,383. These updated projections do not reflect any proposed statutory changes being considered during the 2006 legislative session to the scholarship criteria and award amounts. The TSAC Report is attached.

The estimates provided by each of the presenters are summarized in an attachment to this memorandum. Given the volatility of lottery sales contrasted with the recurring nature of scholarships, the Board consensus was that estimates should continue to be conservative in nature until such time that more experience is gained in Tennessee. Consensus was reached on the following revised estimates of the range for net proceeds of lottery revenues to be deposited in the Lottery for Education Account, to be used for the various statutory purposes:

	FY 2005-06		FY 2006-07	
	Low	High	Low	High
Net Lottery Proceeds	\$260,100,000	\$268,100,000	\$261,900,000	\$272,600,000

The ranges recommended above provide a mean or midrange estimate of \$264,100,000 for fiscal year 2005-06 and of \$267,300,000 for fiscal year 2006-07. Note, this is an upward revision from our December estimates.

Each of us stands ready to discuss this further at your convenience.

Attachments

Revenue Estimates (2)
Lottery Estimates
TSAC Report

cc. The Honorable John S. Wilder
The Honorable Jimmy Naifeh

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2005-2006**

(Accrual - Basis Estimates)

Schedule 1

2005-2006

DEPARTMENT OF REVENUE	2004-2005 ACTUAL	BUDGETED ESTIMATE	% CHANGE OVER 04-05 ACTUAL	1/31/06 REVISED ESTIMATE	% CHANGE OVER 04-05 ACTUAL	DR. FOX ESTIMATE	% CHANGE OVER 04-05 ACTUAL	FISCAL REVIEW ESTIMATE	% CHANGE OVER 04-05 ACTUAL
SOURCE OF REVENUE	ACCURAL								
Sales and use Tax	\$ 6,091,545,800	\$6,346,000,000	4.18%	\$ 6,432,000,000	5.59%	\$ 6,515,000,000	6.95%	\$ 6,502,556,000	6.75%
Gasoline Tax	608,050,800	600,000,000	-1.32%	608,100,000	0.01%	603,000,000	-0.83%	606,082,000	-0.32%
Motor Fuel Tax	173,682,100	174,100,000	0.24%	178,900,000	3.00%	178,900,000	3.00%	178,554,000	2.81%
Gasoline Inspection Tax	63,634,400	64,800,000	1.83%	64,500,000	1.36%	64,500,000	1.36%	64,469,000	1.31%
Motor Vehicle Registration Tax	244,153,800	257,000,000	5.26%	254,000,000	4.03%	250,000,000	2.39%	252,699,000	3.50%
Income Tax	155,919,100	162,200,000	4.03%	165,300,000	6.02%	192,000,000	23.14%	192,230,000	23.29%
Privilege Tax - Less Earmarked Portion (1)	264,933,100	263,600,000	-0.50%	283,500,000	7.01%	304,000,000	14.75%	303,544,000	14.57%
Gross Receipts Tax - TVA	216,214,800	220,500,000	1.98%	221,400,000	2.40%	221,400,000	2.40%	221,188,000	2.30%
Gross Receipts Tax - Other	19,669,400	18,100,000	-7.98%	20,700,000	5.24%	20,700,000	5.24%	20,850,000	6.00%
Beer Tax	17,254,900	17,700,000	2.58%	17,500,000	1.42%	17,700,000	2.58%	17,846,000	3.43%
Alcoholic Beverage Tax	37,115,700	37,400,000	0.77%	38,000,000	2.38%	39,500,000	6.42%	38,600,000	4.00%
Franchise & Excise Taxes	1,371,998,000	1,358,400,000	-0.99%	1,420,000,000	3.50%	1,420,000,000	3.50%	1,470,200,000	7.16%
Inheritance and Estate Tax	82,890,400	92,000,000	10.99%	84,000,000	1.34%	71,000,000	-14.34%	74,128,000	-10.57%
Tobacco Tax	120,512,200	116,000,000	-3.74%	121,000,000	0.40%	125,000,000	3.72%	126,500,000	4.97%
Motor Vehicle Title Fees	11,396,200	11,600,000	1.79%	11,400,000	0.03%	11,200,000	-1.72%	11,168,000	-2.00%
Mixed Drink Tax	43,142,900	44,900,000	4.07%	45,700,000	5.93%	49,000,000	13.58%	48,068,000	11.42%
Business Tax	114,662,900	102,700,000	-10.43%	119,400,000	4.13%	119,400,000	4.13%	121,881,000	6.30%
Severance Tax	1,405,300	1,000,000	-28.84%	1,400,000	-0.38%	1,400,000	-0.38%	1,650,000	17.41%
Coin Operated Amusement Tax	349,700	800,000	128.77%	300,000	-14.21%	300,000	-14.21%	350,000	0.09%
Unauthorized Substance Tax	65,800	400,000	NA	100,000	NA	100,000	NA	1,000,000	NA
TOTAL DEPARTMENT OF REVENUE	\$ 9,638,597,300	\$9,889,200,000	2.60%	\$ 10,087,200,000	4.65%	\$ 10,204,100,000	5.87%	\$ 10,253,563,000	6.38%
GENERAL FUND ONLY (2)	\$ 8,057,205,000	\$8,257,800,000	2.49%	\$ 8,435,200,000	4.69%	\$ 8,546,400,000	6.07%	\$ 8,591,863,000	6.64%
Growth over FY 06 Revised Estimate:									
Total						\$ 116,900,000		\$ 166,363,000	
General Fund						\$ 111,200,000		\$ 156,663,000	

SELECTED TAXES	ACTUAL	BUDGETED	%	REVISED	%	DR. FOX	%	FISCAL REVIEW	%
SALES AND USE TAX	\$ 6,091,545,800	\$6,346,000,000	4.18%	\$ 6,432,000,000	5.59%	\$ 6,515,000,000	6.95%	\$ 6,502,556,000	6.75%
FRANCHISE AND EXCISE TAXES	1,371,998,000	1,358,400,000	-0.99%	1,420,000,000	3.50%	1,420,000,000	3.50%	1,470,200,000	7.16%
INCOME TAX	155,919,100	162,200,000	4.03%	165,300,000	6.02%	192,000,000	23.14%	192,230,000	23.29%
ROAD USER TAXES	1,089,521,100	1,095,900,000	0.59%	1,105,500,000	1.47%	1,096,400,000	0.63%	1,101,804,000	1.13%
ALL OTHER TAXES	929,613,300	926,700,000	-0.31%	964,400,000	3.74%	980,700,000	5.50%	986,773,000	6.15%

(1) Privilege Tax estimates are reduced for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2006-2007**

(Accrual - Basis Estimates)

Schedule 2

2006-2007						
DEPARTMENT OF REVENUE	1/31/06	% CHANGE		% CHANGE		% CHANGE
SOURCE OF REVENUE	BUDGET DOCUMENT	OVER 05-06	DR. FOX	OVER 05-06	FISCAL REVIEW	OVER 05-06
	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE
Sales and use Tax	\$ 6,740,700,000	4.80%	\$ 6,827,700,000	4.80%	\$ 6,801,674,000	4.60%
Gasoline Tax	608,700,000	0.10%	597,000,000	-1.00%	606,082,000	0.00%
Motor Fuel Tax	184,300,000	3.02%	184,300,000	3.02%	180,340,000	1.00%
Gasoline Inspection Tax	65,800,000	2.02%	65,500,000	1.55%	65,114,000	1.00%
Motor Vehicle Registration Tax	259,000,000	1.97%	255,000,000	2.00%	260,280,000	3.00%
Income Tax	175,200,000	5.99%	203,500,000	5.99%	202,803,000	5.50%
Privilege Tax - Less Earmarked Portion (1)	286,000,000	0.88%	313,100,000	2.99%	315,686,000	4.00%
Gross Receipts Tax - TVA	228,000,000	2.98%	228,000,000	2.98%	227,381,000	2.80%
Gross Receipts Tax - Other	21,800,000	5.31%	21,800,000	5.31%	21,788,000	4.50%
Beer Tax	17,700,000	1.14%	17,900,000	1.13%	18,203,000	2.00%
Alcoholic Beverage Tax	38,400,000	1.05%	39,900,000	1.01%	39,565,000	2.50%
Franchise & Excise Taxes	1,448,400,000	2.00%	1,448,400,000	2.00%	1,514,306,000	3.00%
Inheritance and Estate Tax	84,000,000	0.00%	71,000,000	0.00%	75,240,000	1.50%
Tobacco Tax	121,000,000	0.00%	125,000,000	0.00%	125,868,000	-0.50%
Motor Vehicle Title Fees	11,800,000	3.51%	11,400,000	1.79%	11,503,000	3.00%
Mixed Drink Tax	48,500,000	6.13%	51,500,000	5.10%	50,231,000	4.50%
Business Tax	124,300,000	4.10%	124,200,000	4.02%	125,842,000	3.25%
Severance Tax	1,400,000	0.00%	1,400,000	0.00%	1,716,000	4.00%
Coin Operated Amusement Tax	300,000	0.00%	300,000	0.00%	300,000	-14.29%
Unauthorized Substance Tax	100,000	0.00%	100,000	0.00%	1,000,000	0.00%
TOTAL DEPARTMENT OF REVENUE	\$ 10,465,400,000	3.75%	\$10,587,000,000	3.75%	\$10,644,922,000	3.82%
GENERAL FUND ONLY (2)	\$ 8,765,000,000	3.91%	\$ 8,887,200,000	3.99%	\$ 8,938,022,000	4.03%

Growth over FY 07 Budget Document Estimate:

Total	\$121,600,000	\$179,522,000
General Fund	\$122,200,000	\$173,022,000

SELECTED TAXES	BUDGET DOC.	%	DR. FOX	%	FISCAL REVIEW	%
SALES AND USE TAX	\$ 6,740,700,000	4.80%	\$ 6,827,700,000	4.80%	\$ 6,801,674,000	4.60%
FRANCHISE AND EXCISE TAXES	1,448,400,000	2.00%	1,448,400,000	2.00%	1,514,306,000	3.00%
INCOME TAX	175,200,000	5.99%	203,500,000	5.99%	202,803,000	5.50%
ROAD USER TAXES	1,117,800,000	1.11%	1,101,800,000	0.49%	1,111,816,000	0.91%
ALL OTHER TAXES	983,300,000	1.96%	1,005,600,000	2.54%	1,014,323,000	2.79%

(1) Privilege Tax estimates are reduced for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.

**Estimated Revenues Based on Growth Rates
State Funding Board Staff Recommendation
May 2006 Meeting**

	<u>FY 2005-2006</u>	<u>Growth Rate</u>	<u>FY 2006-2007</u>	<u>Growth Rate</u>
Total Taxes	\$ 10,202,500,000	5.85%	\$ 10,559,600,000	3.50%
			\$ 10,585,100,000	3.75%
	\$ 10,255,900,000	6.40%	\$ 10,614,900,000	3.50%
			\$ 10,640,500,000	3.75%
General Fund	\$ 8,544,700,000	6.05%	\$ 8,869,400,000	3.80%
			\$ 8,890,800,000	4.05%
	\$ 8,593,000,000	6.65%	\$ 8,919,500,000	3.80%
			\$ 8,941,000,000	4.05%

State Funding Board
Net Lottery Proceeds Estimates
Actual 2004-2005 and Estimated 2005-2006 and 2006-2007
May 3, 2006

	2004-2005 Actual	2005-2006 Revised	%	2006-2007	%
Lottery Corporation					
Low	227,423,000	260,100,000	14.37%	261,900,000	0.69%
High	227,423,000	268,100,000	17.89%	272,600,000	1.68%
Mid-Range Estimate	227,423,000	264,100,000	16.13%	267,300,000	1.21%
Fiscal Review Staff					
Low	227,423,000	263,586,000	15.90%	264,141,000	0.21%
High	227,423,000	271,432,000	19.35%	272,004,000	0.21%
Mean Estimate	227,423,000	267,050,000	17.42%	267,612,000	0.21%
Recommended Range					
Low	227,423,000	260,100,000	14.37%	261,900,000	0.69%
High	227,423,000	271,400,000	19.34%	272,600,000	0.44%